progressive policy institute

To: The Next President

From: Bob Pozen Chairman,
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Re: A Progressive Fix for Social Security

While this year has been dominated by a high-stakes election and the financial meltdown on Wall Street, 2008 also marks Year One of the baby boomers' long march into retirement. So begins a demographic tidal wave that will reshape our society and—unless we act wisely now—overwhelm our public finances.

The implications for our elected leaders are clear: When it comes to reforming Social Security and Medicare, the future is now. As our next president, you must begin laying the groundwork for a comprehensive update of America's venerable but underfunded social-insurance programs—starting with Social Security.

But why start with Social Security? Doesn't Medicare present a much bigger financial challenge?

It does, and that is exactly the point. Since Social Security is, comparatively speaking, the "easy" fix, it ought to be

repaired first. We know how to fix Social Security, whereas there is less agreement on viable options for reining in health care costs. If we can build a sturdy coalition to reform Social Security, that might make it easier to form a similar bipartisan alliance when we tackle Medicare down the line.

Forging a new spirit of bipartisan trust and cooperation is a prerequisite for entitlement reform. Back in 2001, President Bush tapped me to be one of several Democrats on his Presidential Commission to Strengthen Social Security. That effort foundered on the White House's ideological fixation with private savings accounts funded by payroll tax contributions. By conflating reform with these "carve out" accounts, Republicans repelled Democrats and sowed a legacy of mistrust that has paralyzed candid discussion of Social Security ever since.

The truth is, Social Security faces a substantial funding gap that cannot be closed by stronger economic growth or tax hikes alone. The new demographic realities—fewer workers supporting more retirees—demand that we also restrain future benefit growth. Otherwise, the program's rising costs will continue to crowd out space in the federal budget for public investments in other progressive priorities.

The fairest way to constrain those costs is to adopt what I have called "progressive indexing" of Social Security benefits. Before explaining this idea in detail, let's look at some background.

Social Security: The Basics

Social Security is a mandatory insurance program for all American workers, in which payroll taxes are used to finance workers' retirement benefits. It is financed by a 12.4 percent payroll tax on earnings up to an annual maximum, which in 2008 is $102,000. Retirement benefits under Social Security are based on a complex formula taking into account a worker's average lifetime earnings, wage inflation, and other factors.

The financing challenges of Social Security derive primarily from the changing demographics of the U.S. In 1960, payroll taxes from approximately six workers supported benefits to every retiree; by 2030, there will be only two workers supporting every retiree. Moreover, American retirees will continue to live longer, and therefore receive Social Security benefits for more years.

As a result, the Social Security trustees predict a funding shortfall with a present value of $4.7 trillion over the next 75 years. They estimate that the Social Security Trust Fund will run out of money around 2041[1]. If no reforms are made to Social Security on or before 2041 (that is 33 years from now—when today's thirty-somethings will be in their 60s and early 70s), Congress would either have to slash Social Security benefits by roughly 25 percent or raise payroll taxes to a rate of 18 percent (or some combination of both).

Skeptics of reform have argued that such draconian steps can be avoided if economic growth and wage levels increase faster than assumed by the 2007 Trustees Report. Yet, even if this optimistic scenario were to occur, the impact on Social Security's solvency would not be that large, because higher wages would also mean higher retirement benefits for many workers.

More importantly, the longevity assumptions used by Social Security have generally understated increases in life expectancy. If the biotech industry makes a breakthrough in a major disease like cancer, there could

be a dramatic rise in the life expectancy of American workers.

While the Trust Fund's solvency will be at issue in 2041, Social Security's problems really begin in 2017. In that year, Social Security will go from an annual surplus to an annual deficit as benefits start to exceed payroll taxes.

The impact of this would go well beyond Social Security. Here's why: Historically, both Republican and Democratic administrations have used Social Security's surplus to reduce the federal budget deficit. In 2007, for example, the deficit would have been more than $100 billion higher without the Social Security surplus. After 2017, however, Social Security will run ever-growing deficits of its own, which will make the federal deficit even bigger.

Reforming Social Security: Four Principles to Follow

What can be done to avoid a federal budget crunch starting after 2017—or an outright bankruptcy of Social Security around 2041? Four principles (two do's and two don'ts) should be followed in all reform plans:

1. **Do protect Social Security's character as a social-insurance program whereby every contributing worker receives retirement benefits related to his or her contributions.** The strong political support for Social Security has been grounded in its broad-based application to private-sector workers. This political support would be undermined if Congress adopted "means testing," which would involve taking away all Social Security benefits from workers with annual earnings or retirement income over specified amounts.

2. **Do make Social Security more progressive for low-wage workers.** The tax benefits from all private retirement plans—including defined benefit plans, 401(k) plans and individual retirement accounts—exceed $100 billion per year, and go overwhelmingly to middle-income and high-wage workers. Thus, Social Security should preserve decent benefits to low-wage workers, who generally have no other sources of retirement income.

3. **Don't divert any payroll taxes from Social Security to private "carve out" accounts invested in the securities markets.** This has no support from Democrats, and will be opposed even by some Republicans in light of Wall Street's recent woes. But Social Security reform should be accompanied by expanding "add-on" accounts, like individual retirement accounts, which are not funded by payroll taxes.

4. **Don't reduce benefits for anyone now in retirement or close to retirement.** These workers have long relied on the existing rules for Social Security, and it would be a breach of trust to change those rules on them now that they are at the end of their most productive years.

My proposal for progressive indexing of benefits is consistent with these four principles. It would index, or link, the initial benefits of higher earners to prices rather than to wages, as is currently the case. The effect of such a change would be to limit Social Security benefits for the well-off to the growth in prices—a step that would be mitigated by providing affluent Americans with new opportunities to save money in tax-favored accounts. This would start in 2012 and not apply to anyone in retire-

ment as of that year. The end result would be the protection of Social Security for all Americans, with no diminution of benefits for lower-wage workers.

The Importance of Indexing

Most people believe that Social Security benefits already are based on price indexing because, *after* they retire, their benefits are indexed for inflation (using the consumer price index, or CPI). But that is not actually the case.

The initial calculation of Social Security benefits *at retirement* is based on wage indexing—not price indexing. Upon a worker's retirement, the government calculates his or her average annual earnings over a 35-year career, and then increases that average by the rise in wages over his or her career (not the rise in prices).

This little fact helps explain how price indexing could save Social Security. In the United States, wages have historically risen over 1 percent faster per year than prices. Therefore, the purchasing power of Social Security benefits in 2045 is projected to be roughly 50 percent higher than in 2005 for a comparable worker (in constant dollars).

That is a substantial increase in purchasing power. It would be great if we could afford to offer that boost to all American workers. Unfortunately, we cannot. We can only afford to offer it to some workers, and social equity demands that we reserve it for the lowest 30 percent of wage earners—workers who generally do not have other sources of retirement income. Under progressive indexing, their benefits would not change.

By contrast, most median-wage and high-wage earners receive retirement benefits from private plans—including 401(k) programs—as well as Social Security. Under progressive indexing, the Social Security benefits of high earners (over $90,000 per year in average career earnings) would grow with inflation, while those of middle earners would grow at a rate somewhere between inflation and the rise of wages.

Setting the growth of benefits this way for high- and middle-wage earners would make a real difference, saving literally trillions of dollars. It would reduce the present value of the 75-year deficit of Social Security by somewhere between $2.6 trillion to $3.2 trillion, depending on the precise design of the progressive-indexing program.

What are the alternatives to progressive indexing? Many reformers call for extending the normal retirement age beyond 67 (it will stay at 66 for a few years after 2011 and then rise slowly to 67 in 2027). Such an extension would be logical if linked to rising life expectancy, since that implies receiving retirement benefits for more years. Moreover, the political opposition to this alternative would likely be reduced if the normal retirement age is gradually extended beyond 67 only after a far-off date like 2040.

There are several substantive and political arguments against the proposal to raise the normal retirement age above 67:

- Raising the retirement age is not progressive because it applies equally to workers at different wage levels.
- In practice, such an increase in the retirement age would be more challenging to low-wage workers, since they are more likely to engage in physical labor.

- The difference in life expectancy between low- and high-wage earners is already substantial and appears to be expanding.

- Many Democrats are dead-set against it.

Why Other Approaches Fall Short

Of course, price indexing is hardly the only idea for saving Social Security. Yet when one looks at the alternatives, it becomes clear that they all have grave flaws, which tend to be serious enough to disqualify them.

For example, many progressives call for changing the way we calculate the cost-of-living adjustments for current retirees. Most economists agree that the current methodology overstates the actual rise in consumer prices. The federal government, however, has already worked many of these kinks out of the system, so further improvements in our cost-of-living calculations would not do much to narrow Social Security's 75-year funding gap.

Why not simply raise taxes to cover the Social Security shortfall? If the United States were to boost its payroll tax rate from 12.4 percent to levels found in Western Europe (e.g., 19 percent in Germany), the Social Security deficit would disappear. Problem solved, right?

However, economists generally agree that such a rate increase would hurt economic growth. It also would be quite regressive since the rate increase would be incurred by low earners as well as high earners.

For these reasons, many progressives have focused on raising the amount of wages subject to the payroll tax. During the late 1980s, this maximum wage base covered close to 90 percent of all wages in the economy. But that percentage has slipped to the mid-80s in recent years.

To bring Social Security's wage base back to roughly 90 percent of total wages, you could tweak that formula upward. This, however, would have the perverse result of gradually imposing a 12.4 percent payroll tax on earnings between $102,000 and $200,000 per year, while exempting wages above $200,000 from the payroll tax altogether.

To get around that problem, some Democrats have proposed a "doughnut" approach that would impose a surtax of between 2 percent and 4 percent on all earnings above $200,000. This has the obvious political advantage of taxing a small group of the highest earners, while avoiding further payroll taxes on those earning between $102,000 and $200,000 per year.

Assuming that such a surtax would not involve any increases in Social Security benefits, this could lower the 75-year deficit by $500 billion to $1 trillion depending on its design.

The "doughnut" approach has several drawbacks. First of all, when combined with efforts to roll back the Bush tax cuts for high earners, the surcharge could mean a 25 percent hike in taxes for earnings over $200,000 per year. (This calculation is based on a 4 percent surcharge plus a 4.6 percent income-tax increase for high earners, from a 35 percent tax rate to 39.6 percent.)

Second, if the surtax is not linked to any increase in benefits, this would violate the insurance principles underlying Social Security. As explained above, these insurance principles have been critical in maintaining political support for Social Security.

Since the politics of Social Security reform point toward some combination of benefit

cuts and tax increases, you might want to consider combining progressive indexing with a 2 percent surtax for incomes above $200,000, starting in 2018. To soften the blow, you could ask Congress to lift the existing $150,000 income cap on the Roth IRA.

This way, higher earners would be able to save more on their own, which would help compensate for the slower growth in their Social Security benefits. At the same time, your administration could push for matching tax credits for low earners who sock more of their own money into IRAs.

As our next president, you should make progressive indexing a key part of your reform agenda for this reason: It can put Social Security back on a sound financial footing in a way that preserves Franklin Roosevelt's vision of providing all Americans a basic floor of economic security in old age. And that's more than reason enough.

ENDNOTES

1. The 2007 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, May 1, 2007.

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